REPORT OF THE AUDIT OF THE KENTUCKY LOTTERY CORPORATION

For The Years Ended June 30, 2004 and 2003

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To the People of Kentucky
Honorable Ernie Fletcher, Governor
Honorable David L. Williams, President, Kentucky Senate
Honorable Jody Richards, Speaker, Kentucky House of Representatives
Board of Directors, Kentucky Lottery Corporation

The enclosed report, prepared by Moore Stephens Potter, LLP, Certified Public Accountants, presents the financial and compliance audit of the books and records of the Kentucky Lottery Corporation for the years ended June 30, 2004 and 2003, as required by KRS 154A.130.

We engaged Moore Stephens Potter, LLP to perform the audit in accordance with auditing standards generally accepted in the United States of America. We worked closely with the firm during our report review process.

Respectfully submitted,

Crit Luallen
Auditor of Public Accounts

Enclosure

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KENTUCKY LOTTERY CORPORATION
LOUISVILLE, KENTUCKY

FINANCIAL STATEMENTS AND
INDEPENDENT AUDITOR'S REPORT

June 30, 2004 and 2003

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MOORE STEPHENS POTTER LLP
CERTIFIED PUBLIC ACCOUNTANTS • BUSINESS ADVISORS

INDEPENDENT AUDITOR'S REPORT

To the Auditor of Public Accounts, Commonwealth of Kentucky and
the Board of Directors, Kentucky Lottery Corporation

We have audited the accompanying financial statements of the Kentucky Lottery Corporation (the KLC), a component unit of the Commonwealth of Kentucky, as of and for the years ended June 30, 2004 and 2003 as listed in the table of contents. These financial statements are the responsibility of the KLC's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Kentucky Lottery Corporation as of June 30, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 5, 2004 on our consideration of the KLC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Moore Stephens Potter, LLP

MOORE STEPHENS POTTER, LLP
August 5, 2004

Kentucky Lottery Corporation
Management's Discussion and Analysis

Our discussion of the Kentucky Lottery Corporation's (the KLC) financial performance provides an overview of the KLC's financial activities for the fiscal years ended June 30, 2004 and 2003. Please read it in conjunction with the financial statements, which follow.

Financial Highlights

- Operating revenues for the year were a record $725.2 million, an increase of $51.7 million, or 7.7% over FY 03.
- Gross profit for the year was $233.3 million, an increase of $10.9 million, or 4.9%.
- Operating expenses were $40.4 million or 5.6% of sales compared to $42.3 million or 6.3 % in FY 03.
- Income from operations was $192.9 million, an increase of $12.8 million, or 7.1%.
- Payments to the Commonwealth of Kentucky's KEES/Education programs and the General Fund were $193.5 million, an increase of $12.7 million, or 7%.

Using This Annual Report

The KLC is accounted for as an enterprise fund, reporting on all of the activity's assets and liabilities using the accrual basis of accounting much like a private business activity.

As such, this annual report consists of a series of financial statements, along with explanatory notes to the financial statements and supplemental schedules. The Statements of Net Assets and the Statements of Revenues, Expenses and Changes in Net Assets report the KLC's net assets and changes in them.

To assess the KLC's financial position and financial health, the reader of these statements should pay particular attention to changes in the components of assets and liabilities as set forth on the Statements of Net Assets, and in changes in operating revenues and expenses as set forth in the Statement of Revenues, Expenses and Changes in Net Assets.

Total Assets

Total assets consist primarily of cash and cash equivalents, investments, accounts receivable and capital assets. As shown in Table 1 below, the KLC's total assets decreased $27.7 million from $329.9 in 2003 to $302.2 million in 2004. In 2003, total assets increased $16.8 million during the year from $313.1 million to $329.9 million. Cash, cash equivalents and investments decreased $27.5 million in 2004 from $282.7 million to $255.2 million and in 2003 increased $6.1 million from $276.6 million to $282.7 million. The change in this account is due primarily to an increase or decrease in market value of the KLC's investments. Investments consist of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities carried at fair value. Accounts receivable represents revenue to be collected from the sales of on-line and of instant game tickets to retailers. Capital assets consist of buildings, game equipment, data processing equipment, etc. utilized by the KLC in the sale of on-line and instant game tickets.

Capital Assets

The KLC's investment in capital assets, net of accumulated depreciation in 2004 and 2003 was $16.5 million and $15.7 million, respectively. The investment in capital assets includes buildings, game equipment, data processing equipment, automobiles, software and furniture and fixtures. The total increase in the KLC's investment in capital assets for 2004 was $.8 million or 5.1% compared to $2.6 million or 19% in 2003. The major capital asset event during 2004 and 2003 was the acquisition and development of software related to enhancements in retailer accounts receivable data processing and the implementation of enhanced "e-business" systems and capabilities. Additional information on the KLC's capital assets can be found in Note 6 to the financial statements.

Table 1
Net Assets
(in millions)

	2004	2003	% Change	2002
Current and Other Assets	$76.0	$72.6	4.7%	$69.9
Investments	203.5	236.7	-14.0%	225.5
Capital assets, net	16.5	15.7	5.1%	13.2
Deposits with MUSL	6.2	4.9	26.5%	4.5
Total assets	302.2	329.9	-8.4%	313.1
Current Liabilities	70.4	63.7	10.5%	58.3
Long-term liabilities	182.7	198.9	-8.1%	205.0
Total liabilities	253.1	262.6	-3.6%	263.3
Net Assets				
Invested in capital assets	16.5	15.7	5.1%	12.8
Unrestricted- accumulated unrealized gains on investments	21.7	39.9	-45.6%	22.5
Unrestricted	10.9	11.7	-6.8%	14.5
Total net assets	$49.1	$67.3	-27.0%	$49.8

Liabilities

Table 2
Liabilities
(in millions)

	Current			Long-term		
	2004	2003	2002	2004	2003	2002
Prize liabilities	$ 48.5	$ 49.1	$ 47.8	$ 182.7	$ 198.9	$ 205.0
Due to Commonwealth	14.3	6.4	3.7			
Notes payable	0.0	0.0	0.3			
Accounts payable and other liabilities	7.6	8.2	6.5			
Total liabilities	$ 70.4	$ 63.7	$ 58.3	$ 182.7	$ 198.9	$ 205.0

Total current liabilities increased by $6.7 million or 10.5% in 2004 and $5.4 million or 9.3% in 2003. The account titled "Due to Commonwealth" increased by $7.8 million in 2004 and $2.7 million in 2003. This is a timing issue and represents payments due to the General Fund and the KEES Reserve Fund after the fiscal year end.

Long-term liabilities consist principally of prize liability for prizes paid in installments over several years. Long-term prize liability decreased by $16.2 million or 8.1% in 2004 and $6.1 million or 3% in 2003. This decrease is due to the fact that there were no additions to the pool of installment prizes in 2004 or 2003; everyone who could have chosen to have their prize paid in installments chose single discounted cash payment instead. More detailed information can be obtained in Note 8 to the financial statements.

<u>Net Assets</u>

As shown in Table 1 above, the KLC's net assets in 2004 decreased $18.2 million to $49.1 million. This year's decrease is attributable to the decrease in market value of investments the KLC holds to fund future payments due on annuitized lottery prizes. Accounting principles dictate the KLC record in the financial records the gain or loss related to the change in market value of these investments. Zero-coupon U.S. government bonds have been purchased for the payment of installment prize awards and are generally held to maturity. The change in the market value of these investments (i.e. the unrealized losses on investments) is recorded as a decrease in unrestricted net assets. The accumulated unrealized gain on investments included in unrestricted net assets at June 30, 2004 is not available for transfer to the Commonwealth's general fund. The KLC's investment in capital assets, net of related debt, of $16.5 million is also not available for transfer to the Commonwealth's general fund as these assets are utilized in the KLC's day-to-day operations. The remaining net assets of $10.9 million are unrestricted and are available for transfer to the Commonwealth's general fund based on the KLC's cash flow and working capital requirements. In 2003, net assets increased $17.5 million to $67.3 million. The increase is attributable to the increase in market value of investments the KLC holds to fund future payments due on annuitized lottery prizes. The change in the market value of these investments (i.e. the unrealized gains on investments) is recorded as an increase in unrestricted net assets.

<u>Changes in Net Assets</u>

<u>Table 3</u>
Changes in Net Assets
(in millions)

	2004	2003	2002
Total operating revenues	$ 725.2	$ 673.5	$ 638.7
Total direct costs	491.9	451.1	431.0
Gross profit	233.3	222.4	207.7
Total operating expenses	40.4	42.3	41.2
Operating income	192.9	180.1	166.5
Total nonoperating expense	211.1	162.6	164.2
Increase (decrease) in net assets	$ (18.2)	$ 17.5	$ 2.3

See Statements of Revenues, Expenses and Changes in Net Assets for items included in each line of Table 3 above. See Tables 4, 5 and 6 below for explanation of differences in the above items for 2004 and 2003.

Sales and Prize Expenses

Sales

Table 4 below compares sales, prizes, unclaimed prizes and gross margin (sales minus net prizes) for each lottery game category, FY 2004, FY 2003 and FY 2002. In 2004, the KLC produced record sales of $725.2 million, an increase of $51.7 million or 7.7% over 2003 and record gross margin of $286 million, an increase of $14.7 million or 5.4% over 2003. Additional total sales record achieved in 2004 included record second quarter sales, which was also the best quarterly sales in KLC history.

Instant tickets are composed of two product categories, Scratch-off tickets and Pull-tab tickets. Scratch-off ticket sales, which accounted for 49.2% of all KLC sales, reached an all time high in 2004 at $357 million, an increase of $37.1 million or 11.6% over 2003. Sales growth within this product category was obtained at the $1, $5 and $10/$20 price points with increases of $3.4 million or 4.5%, $11.9 million or 19.6% and $25 million or 52%, respectively. The $10/$20 price point accounted for 67.4% of the increase in sales of Scratch-off tickets. Sales decline was recognized at the $2 price point with a decrease of $2.9 million or 2.1%. No tickets were introduced at the $3 price point. Pull-Tab tickets experienced its fourth consecutive annual decline with sales of $ 28.7 million in 2004.

In 2003, the KLC produced sales of $673.5 million, a 5.4% increase over 2002 and gross margin of $271.3 million, a 6.6% increase over 2002. Scratch-off ticket sales, which accounted for 47.5% of all KLC sales, reached $319.9 million, an increase of $22.1 million or 7.4% over 2002. Sales growth within this product category was obtained at the $2, $5 and $10/$20 price points with increases of $7 million or 5.5%, $20.5 million or 50.7% and $17.8 million or 59.3%, respectively. Sales declines were recognized at the $1 and $3 price points with decreases of $10 million or 11.7% and $13.2 million or 97.7%, respectively. Pull-Tab tickets experienced a decline in sales of $.6 million in 2003.

The Daily games, Pick 3 and Pick 4 with drawings twice-a-day Monday through Saturday and once on Sunday, both achieved record sales in 2004 of $126 million and $33.7 million, respectively, increases over 2003 of $700,000 or .6 % and $1.3 million or 4%, respectively. Again a spate of triple-digit combinations drawn throughout the year helped spur Pick 3 sales and allowed it to finish the year with about 37.1% of the 2004 On-line market share. In 2003 Pick 3 and Pick 4 achieved sales of $125.3 million and $32.4 million, increases over 2002 of $2.6 million or 2.1% and $2.7 million or 9.1%, respectively. Triple-digit combinations drawn throughout the year helped spur Pick 3 sales and allowed it to finish the year with about 39% of the 2003 On-line market share generating the second-highest sales volume of any product (after Scratch-Off games).

The Kentucky Cash Ball product, which was introduced in March 2001, is a "mini-lotto" type game where players pick two sets of numbers for each draw from a matrix of "4 of 33" for the first set and "1 of 31" for the second set. Cash Ball sales for 2004 were $19.9 million, which was $600,000 or 2.9% less than 2003, but more than $1.9 above quota. The first full year of six days a week drawings helped boost Kentucky Cash Ball sales in 2003. Cash Ball sales for 2003 were $20.5 million, which was $3.4 million or 19.9% more than 2002, but more than $500,000 below quota.

In September 2001, the KLC introduced Lotto South as a replacement game for Lotto Kentucky. The KLC participates in this game with the Georgia and Virginia lotteries. The increased population base allows for higher and faster growing jackpots than the KLC could generate on its own. Despite those attributes, Lotto South sales for 2004 continued to decline to $23.9 million, $.6 million or 2.5% less than 2003 sales, but $3.1 million above quota. Lotto South sales for 2003 declined to $24.5 million about $500,000 more than quota, but $2.7 million or 9.9% less than 2002 Lotto Kentucky/Lotto South sales.

Table 4
Lottery Sales
(in millions)

	Scratch-off			Pull-tab			Pick 3		
	2004	2003	2002	2004	2003	2002	2004	2003	2002
Sales	$ 357.0	$ 319.9	$ 297.8	$ 28.7	$ 31.5	$ 32.1	$ 126.0	$ 125.3	$ 122.7
Gross Prizes	242.8	215.7	199.3	20.1	22.0	22.4	80.4	75.7	78.1
Less Unclaimed Prizes	(4.9)	(3.5)	(2.5)	(0.2)	(0.5)	(0.4)	(1.0)	(0.9)	(1.0)
Net Prizes	237.9	212.2	196.8	19.9	21.5	22.0	79.4	74.8	77.1
Gross Margin	$ 119.1	$ 107.7	$ 101.0	$ 8.8	$ 10.0	$ 10.1	$ 46.6	$ 50.5	$ 45.6

	Pick 4			Extra			Powerball		
	2004	2003	2002	2004	2003	2002	2004	2003	2002
Sales	$ 33.7	$ 32.4	$ 29.7	$ 2.1	$ 4.8	$ -	$ 133.9	$ 114.6	$ 112.1
Gross Prizes	16.5	18.5	16.0	1.4	3.1	-	66.1	56.5	56.0
Less Unclaimed Prizes	(0.3)	(0.4)	(0.4)	(0.1)	-	-	(3.9)	(5.5)	(4.4)
Net Prizes	16.2	18.1	15.6	1.3	3.1	-	62.2	51.0	51.6
Gross Margin	$ 17.5	$ 14.3	$ 14.1	$ 0.8	$ 1.7	$ -	$ 71.7	$ 63.6	$ 60.5

	KY Cash Ball			Lotto South/ Lotto KY			Total		
	2004	2003	2002	2004	2003	2002	2004	2003	2002
Sales	$ 19.9	$ 20.5	$ 17.1	$ 23.9	$ 24.5	$ 27.2	$ 725.2	$ 673.5	$ 638.7
Gross Prizes	10.9	10.5	8.6	12.4	13.1	13.5	450.6	415.1	393.9
Less Unclaimed Prizes	(0.4)	(0.4)	(0.5)	(0.6)	(1.7)	(0.5)	(11.4)	(12.9)	(9.7)
Net Prizes	10.5	10.1	8.1	11.8	11.4	13.0	439.2	402.2	384.2
Gross Margin	$ 9.4	$ 10.4	$ 9.0	$ 12.1	$ 13.1	$ 14.2	$ 286.0	$ 271.3	$ 254.5

Powerball sales reached a record $133.9 million, an increase of $19.3 million or 16.9% over 2003. The Powerball jackpot exceeded $100 million on 5 different runs during the year with the largest jackpot reaching $260 million. Powerball sales accounted for 18.5% of total sales and generating the second-highest sales volume of any product (after Scratch-Off games). In 2003, Powerball sales totaled $114.6 million, which was $2.5 million or 2.2% increase over 2002. Sales were fuelled by three jackpot runs that reached at least $100 million—including a record $315 million jackpot in December 2002 that generated almost $35 million in sales over the course of 17 draws.

Extra Cash was introduced in January 2003, as a new instant-win feature available for Pick 3 and Pick 4. A Player purchases a Pick 3 or Pick 4 play and chooses the extra cash wager. If any Extra Cash numbers match any Pick 3 or Pick 4 numbers in any order, you win the cash amount shown for the matched numbers. The game was ended in 2004 with sales reaching $2.1 million. Sales in 2003 for Extra Cash were $4.8 million.

Prize Expense

In general, prize expense by game should increase or decrease from year to year in proportion to the increase or decrease in sales for a particular game. However, except for the instant game product category, prize expense is also impacted by the luck of the draw. Prize expense for the instant game product category is controllable, to a large degree, by printing a predetermined number and value of winning tickets in the production of each instant game. Prize expense for all of the other lottery products is not predetermined. While each of these lottery products is designed to yield a certain ratio of prizes to sales over a large number of drawings, actual prize payout is determined by lottery players' luck in matching the particular set of numbers randomly selected in each drawing for each game. With that background, Table 4 shows the prize payout by lottery product for 2004, 2003 and 2002.

Gross prize expense in 2004 of $450.6 million reflects an 8.6% increase from 2003 gross prize expense of $415.1 million. The increase in gross prize expense is .9% higher than the increase in sales. Following is a discussion of notable variances in prize expense within certain product categories.

Within product lines, gross prize expense for the instant games increased 10.6% while sales from instant games increased 9.8%. This reflects the continuing shift to the higher price points (more $5, $10 and $20 games) as was discussed in the Scratch-off sales above. As a rule, games with higher price points payout more in prizes than games that sell with a lower price.

Gross prize expense for on-line games increased 5.8%, while sales from on-line games increased 5.4%. KY Cash Ball gross prize expense increased 3.8% while sales decreased 2.9%. Lotto South gross prize expense decreased 5.3% but sales decreased 2.5%. Gross prize expense for Pick 3 increased 6.2% compared with a .5% increase in Pick 3 sales. The difference for these three games is due to players' overall greater luck in 2004 in matching the random numbers selected for each drawing. Gross prize expense for Pick 4 decreased 10.8% compared with a 4% increase in Pick 4 sales.

Net prize expense in 2004 was $439.2 million or 60.6% of sales compared to $402.2 million or 59.7% of sales in 2003. Unclaimed prizes in 2004 were $11.4 million compared to 12.9 million in 2003.

In 2003, gross prize expense of $415.1 million reflects a 5.4% increase from 2002 gross prize expense of $393.9 million. The 5.4% increase is the same percentage increase that product sales experienced in 2003. Following is a discussion of notable variances in prize expense within certain product categories.

Within product lines, gross prize expense for the instant games increased 7.2% while sales from instant games increased 6.5%. This reflects the shift to the higher price points (more $2, $5 and $10 games) as was discussed in the Scratch-off sales discussion above.

Gross prize expense for on-line games increased 2.9% while sales from on-line games increased 4.3%. Gross prize expense for Pick 4 increased 15.6% compared with a 9.1% increase in Pick 4 sales. KY Cash Ball gross prize expense increased 22% while sales increased 19.9%. Lotto South gross prize expense decreased 3%, but sales decreased 9.9%. The difference for these three games is due to players' overall greater luck in 2003 in matching the random numbers selected for each drawing. Gross prize expense for Pick 3 decreased 3.1% in 2003, compared with a 2.1 % increase in Pick 3 sales.

Net prize expense in 2003 was $402.2 million or 59.7% of sales compared to $384.2 million or 60.2% of sales in 2002. Unclaimed prizes in 2003 were $12.9 million compared to $9.7 million in 2002.

Other Expenses

Table 5
Commissions, Operating, and Other Expenses
(in millions)

	2004	2003	% Change	2002
Retailer commissions	$ 45.1	$ 41.5	8.7%	$ 39.8
Ticket costs	$ 7.6	$ 7.4	2.7%	$ 7.0
Operating expenses	$ 40.4	$ 42.3	-4.5%	$ 41.2
Amortization of prize discount	$ 14.4	$ 16.3	-11.7%	$ 15.1
Interest expense	$ -	$ -	N/A	$ 0.1

Retailer commissions cover base selling and cashing commissions as well as a retailer incentive plan based on the sale of instant tickets. Retailer commissions for 2004 and 2003 were 6.2% of sales. Ticket costs include the cost to produce and ship instant tickets. Ticket costs for 2004 and 2003 were 1.0% and 1.1%, respectively. Even with sales increasing 7.7% in 2004, operating expenses decreased $1.9 million from 2003 and were 5.6% of sales. In 2003, operating expenses declined from 6.5% of sales in 2002 to 6.3%. Amortization of prize discount, which reflects the periodic write-off of the difference between the present value of installment prizes and the face value of said prizes, decreased $1.9 million in 2004 and increased by $1.3 million or 8.5% in 2003.

Other Revenues

Table 6
Other Revenues
(in millions)

	2004	2003	% Change	2002
Increase (decrease) in fair value of investments	$ (3.7)	$ 33.8	-110.9%	$ 22.7
Interest income	$ 0.3	$ 0.7	-57.1%	$ 0.7
Other miscellaneous revenue	$ 0.2	$ 0.2	0.0%	$ 0.2

Increase or decrease in fair value of investments represents the change in market value of the KLC's investments held to fund prize installments. Since the KLC typically holds its investments to maturity to provide a secure funding vehicle for future prize payments, gain or loss in market value does not affect ongoing operations.

Interest income consists principally of interest on the KLC's cash balance, which is invested in short-term investments. The decline in interest income reflects the general decline in interest rates in 2004 and 2003.

Miscellaneous revenues consist primarily of various fees assessed to retailers and income earned from a security-lending program.

Payments to the Commonwealth of Kentucky

In 2004, payments to the Commonwealth of Kentucky represent a transfer of funds from the KLC to the Commonwealth's general fund and the KEES Program Reserve Account. Payments to the general fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are appropriated by the General Assembly to provide funding for postsecondary education and literacy development. Payments to the KEES Reserve Account are used to provide funding for postsecondary education. In 2003, funds were also transferred to the Affordable Trust Fund to address the critical housing needs of extremely low income Kentuckians. Payments to the Commonwealth of Kentucky in 2004 were a record $193.5 million, an increase of $12.7 million or 7% over 2003. Payments in 2003 were $180.7 million, an increase of $8 million or 4.7% over 2002.

Currently Known Facts, Decisions, or Conditions

On January 20, 2004 the Tennessee Education Lottery Corporation began selling their first scratch-off tickets and on April 19 they started selling Powerball tickets. Research done by the KLC indicates that approximately 11% of total KLC sales and 20% of KLC Powerball sales are derived from individuals who reside in Tennessee. Research indicates that in 2004, the KLC lost $12.2 million in revenues and $3.3 million in dividends. In 2005, the KLC could lose up $67 million in sales and dividends of $18.5 million.

Contacting the KLC's Financial Management

This financial report is designed to provide the public and other interested parties with an overview of the financial results of the KLC's activities, and to show the KLC's accountability for the revenue that it generates. If you have any questions about this report or need additional financial information, contact the Chief Financial Officer at the Kentucky Lottery Corporation, 1011 West Main Street, Louisville, Kentucky 40202.

KENTUCKY LOTTERY CORPORATION
STATEMENTS OF NET ASSETS
June 30, 2004 and 2003
(dollars in thousands)

	2004	2003
ASSETS		
Current assets:		
Cash and equivalents	$ 24,159	$ 18,099
Investments at fair value, current portion	27,602	27,911
Accounts receivable, net	23,256	25,580
Ticket inventories	340	264
Other	634	812
Total current assets	75,991	72,666
Noncurrent assets:		
Investments at fair value, less current portion	203,482	236,667
Capital assets, net	16,496	15,661
Deposits with Multi-State Lottery Association	6,244	4,925
Total noncurrent assets	226,222	257,253
Total assets	302,213	329,919
LIABILITIES		
Current liabilities:		
Accounts payable and accrued expenses	7,600	8,206
Due to Commonwealth	14,261	6,429
Estimated prize liability, current portion	48,533	49,099
Total current liabilities	70,394	63,734
Noncurrent liabilities:		
Estimated prize liability, less current portion	182,671	198,835
Total liabilities	253,065	262,569
NET ASSETS		
Invested in capital assets, net of related debt	16,496	15,661
Unrestricted	32,652	51,689
Total net assets	$ 49,148	$ 67,350

See accompanying notes.

KENTUCKY LOTTERY CORPORATION
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
for the years ended June 30, 2004 and 2003
(dollars in thousands)

	2004	2003
Operating revenues:		
Instant games	$ 385,721	$ 351,425
On-line games	339,531	322,060
Total operating revenues	725,252	673,485
Direct costs:		
Prize expense:		
Instant games	257,821	233,639
On-line games	181,368	168,517
Total prize expense	439,189	402,156
Commissions to retailers	45,127	41,521
Ticket costs	7,606	7,408
Total direct costs	491,922	451,085
Gross profit	233,330	222,400
Operating expenses:		
Advertising and promotion	10,554	10,615
Salaries, wages and benefits	12,230	11,940
Contracted and professional services	11,487	11,473
Depreciation	2,194	2,184
Other general and administrative	3,944	6,095
Total operating expenses	40,409	42,307
Operating income	192,921	180,093
Nonoperating income (expense):		
Payments to the Commonwealth of Kentucky	(193,478)	(180,729)
Investment income	(3,423)	34,284
Interest expense	(14,455)	(16,336)
Other income	233	199
Total nonoperating income (expense)	(211,123)	(162,582)
Increase (decrease) in net assets	(18,202)	17,511
Net assets, beginning of year	67,350	49,839
Net assets, end of year	$ 49,148	$ 67,350

See accompanying notes.

KENTUCKY LOTTERY CORPORATION
STATEMENTS OF CASH FLOWS
for the years ended June 30, 2004 and 2003
(dollars in thousands)

	2004	2003
Cash flows from operating activities:		
Cash received from customers	$ 727,506	$ 665,489
Cash payments to suppliers for goods and services	(535,076)	(482,180)
Cash payments to employees for services	(12,225)	(11,940)
Net cash provided by operating activities	180,205	171,369
Cash flows from noncapital financing activities:		
Payments to the Commonwealth of Kentucky	(185,646)	(177,992)
Cash flows from capital and related financing activities:		
Purchases of capital assets, net	(3,076)	(4,575)
Proceeds from disposal of equipment	75	39
Repayments of long-term debt	-	(339)
Interest expense	-	(4)
Net cash used in capital and related financing activities	(3,001)	(4,879)
Cash flows from investing activities:		
Proceeds from sale of investments	16,070	13,466
Purchase of investments	(573)	(7,349)
Deposits with Multi-State Lottery Association	(1,319)	(395)
Investment income	324	469
Net cash provided by investing activities	14,502	6,191
Net increase (decrease) in cash and equivalents	6,060	(5,311)
Cash and equivalents at beginning of year	18,099	23,410
Cash and equivalents at end of year	$ 24,159	$ 18,099

See accompanying notes.

KENTUCKY LOTTERY CORPORATION
STATEMENTS OF CASH FLOWS (CONTINUED)
for the years ended June 30, 2004 and 2003
(dollars in thousands)

	2004	2003
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 192,921	$ 180,093
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	2,194	2,184
Bad debt expense	70	190
Increase (decrease) in cash due to changes in:		
Accounts receivable, net	2,254	(7,996)
Ticket inventories	(76)	255
Deposits with Commonwealth of Kentucky	-	115
Other assets	178	(350)
Accounts payable and accrued expenses	(606)	1,765
Estimated prize liability	(16,730)	(4,887)
Total adjustments	(12,716)	(8,724)
Net cash provided by operating activities	$ 180,205	$ 171,369

Noncash capital and investing activities:

The accretion of interest on investments held to fund grand prizes, which increased prize liability totaled $14,455 and $16,332 for the years ended June 30, 2004 and 2003, respectively.

The fair value of investments decreased $18,202 in 2004 and increased $17,483 in 2003.

The purchase of property and equipment included in accounts payable totaled $70 and $117 at June 30, 2004 and 2003, respectively.

See accompanying notes.

NOTE 1 - ORGANIZATION

The Kentucky Lottery Corporation (the KLC) was created with the enactment of House Bill No. 1 in December 1988 as an independent de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (the Commonwealth). The KLC is to be managed in such a manner that enables the people of the Commonwealth to benefit from its profits and to enjoy the best possible lottery games. The operations of the KLC are separate and distinct from other operations of the Commonwealth.

The KLC commenced operations on April 4, 1989 with the sale of instant game tickets. Sales of on-line games began October 16, 1989. In January 1991, the KLC joined the Multi-State Lottery Association, a group of states that combine lottery sales for on-line games.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity:

The KLC has adopted the provisions of Government Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, under which the financial statements include all the organizations, activities, functions and component units for which the KLC is financially accountable. Financial accountability is defined as the appointment of a voting majority of the component unit's board, and either (1) the KLC's ability to impose its will over the component unit, or (2) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the KLC.

The KLC has determined that no outside agency meets the above criteria and, therefore, no other agency has been included as a component unit in the KLC's financial statements. In addition, since the KLC provides a financial benefit for the Commonwealth, the KLC is part of the reporting entity of the Commonwealth and is, therefore, included in the Commonwealth's Annual Financial Report as a blended component unit. The accompanying financial statements are not intended to present the financial position or the results of operations and cash flows of the Commonwealth of Kentucky or its proprietary funds.

Basis of Presentation:

The KLC is accounted for as an enterprise fund. The financial statements are prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. The KLC has elected to apply all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The KLC has further elected not to apply FASB pronouncements issued after November 30, 1989, in accordance with GASB Statement No. 20.

As an enterprise fund, the KLC distinguishes *operating* revenues and expenses from *nonoperating* items. Operating revenues and expenses generally result from providing services and delivering goods in connection with the KLC’s principal ongoing operations. The principal operating revenues of the KLC are charges to customers for sales of lottery products. Operating expenses include the cost of sales and services, selling and administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Basis of Presentation (continued):

In June 1999, GASB unanimously approved Statement No. 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*. This statement was required to be implemented for the KLC for the year ended June 30, 2002. For the first time the financial statements included a Management's Discussion and Analysis (MD&A) section providing an analysis of the KLC's overall financial position and results of operations. This and other changes are reflected in the accompanying financial statements (including notes to the financial statements).

Revenue and Accounts Receivable Recognition:

Revenue and accounts receivable for on-line games are recognized when tickets are sold to the public by contracted retailers.

Revenue and accounts receivable for instant games are recognized upon activation or issuance of tickets for sale by the retailers, or 50 days from the date of issuance of the tickets to the retailers, whichever is sooner.

Allowance for Doubtful Accounts:

The KLC uses the allowance method to account for uncollectible accounts receivable.

Prizes:

Prize expense for instant ticket games is recorded as an estimate at the time the related revenue is recognized based on the predetermined prize structure for each game; periodically, the prize expense is adjusted to reflect amounts actually won. Prize expense for on-line games is recorded at the time the related revenue is recognized based on the known prize payout structure.

Grand prizes are awarded related to the Lotto Kentucky, Lotto South and Powerball on-line games. Lotto Kentucky grand prizes are paid in twenty equal annual installments or in a single lump-sum payment equal to the estimated present cash value of twenty annual payments. For Lotto Kentucky winners electing annual installments, the actual prize expense is the cost of the U.S. Treasury zero coupon bonds which the KLC purchases to fund the annual payments. For Lotto Kentucky winners electing present cash value, the actual prize expense is the lump-sum payment equal to the cost of U.S. Treasury zero coupon bonds, priced seven days prior to the draw date, as if the KLC was to fund twenty equal annual installments.

Lotto South grand prizes are paid in thirty equal annual installments or in a single lump-sum payment equal to the estimated present cash value of thirty annual payments. The KLC recognizes Lotto South prize expense at the time the related revenue is recognized based on the known prize payout structure. A portion of Lotto South sales of the KLC is remitted to the Virginia State Lottery, the designated administrator for Lotto South, to fund prize payments. All Lotto South grand prizes for winners electing annual installments are funded through the purchase of U.S. Government agency securities. The Party Lottery which sold the grand prize winning ticket has the first option of purchasing the investments, but may defer the purchase to another Party Lottery.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Prizes (continued):

Powerball grand prizes are paid in thirty equal annual installments or in a single lump-sum payment equal to the estimated present cash value of twenty-five annual payments. The KLC recognizes Powerball prize expense at the time the related revenue is recognized based on the known prize payout structure. A portion of Powerball sales of the KLC is remitted to the Multi-State Lottery Association (MUSL) to fund prize payments. MUSL purchases U.S. Government agency securities to fund prize liability to Powerball winners electing annual installments.

Cash and Equivalents:

For financial statement purposes, the KLC considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Investments:

Investments consist of U.S. Treasury zero coupon bonds and other U.S. Government agency securities carried at fair value in accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. Fair value of investments is based on quoted market prices. Investments are in U.S. Treasury zero coupon bonds and are purchased to meet future installment payments to prize winners. There are generally no available realized gains or losses on investments, as it is the KLC's policy to hold the investments to maturity.

Ticket Inventories:

Inventories are carried at cost (as determined by the specific identification method) and consist of pull-tab tickets located in the KLC's warehouses or held by retailers. The cost of tickets is charged to operations upon the recognition of revenue under the procedures described above.

Capital Assets:

Capital assets are carried at cost less accumulated depreciation. The KLC defines capital assets as assets with an initial, individual cost of more than $500 and an estimated useful life in excess of one year. Depreciation is computed using the straight-line method over estimated lives of three to thirty years. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal. Amortization of leasehold improvements is computed using the straight-line method over lease terms of three to five years.

Deposits with Multi-State Lottery Association (MUSL):

Deposits are carried at cost. MUSL is an unincorporated government-benefit voluntary association created for the purpose of administering joint lottery games, such as Powerball and Instant Powerball TV Game Show. MUSL currently includes 27 state lottery entities, the District of Columbia and the U.S. Virgin Islands. The chief executive officer of each member lottery serves on the MUSL board of directors. As a member of MUSL, the KLC is required to contribute to various prize reserve funds maintained by MUSL. The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities. All prize reserve funds remitted, and the related interest earnings, will be returned to the KLC upon leaving MUSL, less any portion of unanticipated prize claims which may have been paid from the fund.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Compensated Absences:

It is the KLC's policy to permit employees to accumulate earned but unused vacation and sick pay benefits. There is no liability recorded for unpaid accumulated sick leave since the KLC does not have a policy to pay unused amounts when employees separate from service. All vacation pay is accrued when incurred. Accrued vacation totalling approximately $711,000 and $776,000 as of June 30, 2004 and 2003, respectively, is included in accrued expenses in the accompanying statements of net assets.

Estimated Prize Liability:

A liability for grand prize winners electing equal annual installments is recorded based on the cost of U.S. Treasury zero coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. The estimated prize liability is presented in the statement of net assets net of this imputed interest. Imputed interest is amortized to interest expense over the life of the annuity utilizing the effective interest method.

Use of Estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Reclassifications on Previously Issued Financial Statements:

Certain accounts on the financial statements as of June 30, 2003 and for the year then ended have been reclassified to be consistent with the classifications adopted for the financial statements as of June 30, 2004 and for the year then ended. There is no effect on net working capital, total assets, total liabilities, total net assets or the increase in net assets as previously reported.

NOTE 3 - CASH AND EQUIVALENTS

Cash and equivalents includes bank balances of approximately $375,000 and $72,000 at June 30, 2004 and 2003, respectively, which are fully covered by federal depository insurance. Also included in cash and equivalents at June 30, 2004 and 2003 are overnight repurchase agreements of $24,545,000 and $16,783,000, respectively, which are classified as Category 1 deposits. The KLC's deposits are categorized to give an indication of the level of credit risk assumed by the KLC at year-end. Category 1 is comprised of deposits that are either insured or collateralized with securities held by the KLC or by the KLC's agent in the KLC's name.

NOTE 4 - INVESTMENTS

The KLC has adopted GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, which establishes accounting and reporting guidelines for government investments and investment pools. The adoption of this statement requires investments to be presented at fair value.

NOTE 4 - INVESTMENTS (CONTINUED)

All investments held at June 30, 2004 and 2003 were classified as Category 1 and were held in U.S. Treasury zero coupon bonds and other U.S. Government agency securities. Category 1 is comprised of investments that are either insured or registered or securities held by the KLC or by the KLC's agent in the KLC's name. Grand prize investments at June 30, 2004 and 2003 consisted of the following (in thousands):

	2004	2003
Direct U.S. Treasury Investments	$ 101,080	$ 117,090
Other U.S. Governmental Agency Securities	130,004	147,488
Total investments	$ 231,084	$ 264,578

The net increase (decrease) in the fair value of investments includes all changes in fair value that occurred during the year. The components of investment income for the years ended June 30, 2004 and 2003 consisted of the following (in thousands):

	2004	2003
Net increase (decrease) in fair value of investments	$ (3,747)	$ 33,832
Interest income	321	436
Security lending income	3	16
Total investment income	$ (3,423)	$ 34,284

When compared to the historical cost method, recording investments at fair value results in a reduction of income of $18,202,000 in 2004 and an increase in income of approximately $17,483,000 in 2003.

Unrealized gains accumulated in unrestricted net assets at June 30 are as follows (in thousands):

	2004	2003
Unrestricted net assets excluding unrealized gains on investments	$ 10,903	$ 11,738
Unrealized gains on investments	21,749	39,951
Total unrestricted net assets	$ 32,652	$ 51,689

NOTE 4 - INVESTMENTS (CONTINUED)

The KLC is authorized by state statutes and investment policies approved by the Board of Directors to lend its investment securities. The lending is managed by the KLC's custodial bank. All loans can be terminated on demand by either the KLC or the borrowers, although the average term of loans is approximately one week. The custodial bank and its affiliates are prohibited from borrowing the KLC's securities.

The custodial bank lends the KLC's U.S. Treasury zero coupon bonds and other U.S. Government agency securities for securities collateral of 102 percent. The securities lending contracts do not allow the KLC to pledge or sell any collateral securities unless the borrower defaults. There are no restrictions on the amount of securities that can be lent at one time or to one borrower.

At June 30, 2004 and 2003, the KLC had loaned investments with fair values of approximately $4,889,000 and $18,542,000, respectively, to authorized brokers for a fee. In exchange for the loaned investments, the KLC has temporarily received direct obligations of the U.S. Treasury and securities issued by U.S. Government agencies with fair values of approximately $5,146,000 and $19,299,000 at June 30, 2004 and 2003, respectively, which are held by the KLC's custodial bank in the KLC's name. The KLC's loaned investments are included in the investments reported in the financial statements rather than the securities received in the exchange.

The lending agent provides indemnification if the borrowers fail to return the underlying securities (and if the collateral is inadequate to replace the securities lent) or fail to pay income distributions on them. There were no violations of legal or contractual provisions, no borrower or lending agent default losses, and no recoveries of prior-period losses during the year. There are no income distributions owing on the securities lent. All borrower rebates, agent fees, and lender's net earnings were fully paid at year-end.

NOTE 5 - ACCOUNTS RECEIVABLE

Accounts receivable at June 30 consisted of the following (in thousands):

	2004	2003
Accounts receivable	$ 23,668	$ 25,935
Allowance for doubtful accounts	(412)	(355)
Accounts receivable, net	$ 23,256	$ 25,580

NOTE 6 - CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2004 was as follows (in thousands):

2004

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets not being depreciated:				
Land	$ 423	$ -	$ -	$ 423
Software development in progress	6,341	-	(6,341)	-
Total capital assets not being depreciated	6,764	-	(6,341)	423
Other capital assets:				
Buildings	7,198	5	-	7,203
Leasehold improvements	332	1	-	333
Game equipment	10,082	944	(791)	10,235
Data processing equipment	16,505	8,096	(402)	24,199
Automobiles, furniture and fixtures	3,709	327	(373)	3,663
Total other capital assets at cost	37,826	9,373	(1,566)	45,633
Less accumulated depreciation for:				
Buildings	(1,369)	(240)	-	(1,609)
Leasehold improvements	(324)	(4)	-	(328)
Game equipment	(9,684)	(129)	791	(9,022)
Data processing equipment	(14,218)	(1,577)	399	(15,396)
Automobiles, furniture and fixtures	(3,334)	(244)	373	(3,205)
Total accumulated depreciation	(28,929)	(2,194)	1,563	(29,560)
Other capital assets, net	8,897	7,179	(3)	16,073
Net capital assets	$ 15,661	$ 7,179	$ (6,344)	$ 16,496

NOTE 6 - CAPITAL ASSETS (CONTINUED)

Capital asset activity for the year ended June 30, 2003 was as follows (in thousands):

2003

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets not being depreciated:				
Land	$ 423	$ -	$ -	$ 423
Software development in progress	2,509	3,832	-	6,341
Total capital assets not being depreciated	2,932	3,832	-	6,764
Other capital assets:				
Buildings	7,143	55	-	7,198
Leasehold improvements	327	5	-	332
Game equipment	9,993	89	-	10,082
Data processing equipment	16,161	472	(128)	16,505
Automobiles, furniture and fixtures	3,697	294	(282)	3,709
Total other capital assets at cost	37,321	915	(410)	37,826
Less accumulated depreciation for:				
Buildings	(1,130)	(239)	-	(1,369)
Leasehold improvements	(315)	(9)	-	(324)
Game equipment	(9,348)	(336)	-	(9,684)
Data processing equipment	(12,999)	(1,310)	91	(14,218)
Automobiles, furniture and fixtures	(3,302)	(288)	256	(3,334)
Total accumulated depreciation	(27,094)	(2,182)	347	(28,929)
Other capital assets, net	10,227	(1,267)	(63)	8,897
Net capital assets	$ 13,159	$ 2,565	$ (63)	$ 15,661

NOTE 7 - NOTES PAYABLE

The KLC had a note payable which matured September 2002. Note payable activity for the years ended June 30, 2004 and 2003 was as follows (in thousands):

Year ending June 30,	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year
2004	$ -	$ -	$ -	$ -	$ -
2003	$ 339	$ -	$ (339)	$ -	$ -

NOTE 8 - ESTIMATED PRIZE LIABILITY

Estimated prize liability at June 30 consisted of the following (in thousands):

	2004	2003
Current:		
Grand prizes	$ 29,848	$ 29,848
Other prizes	18,685	19,251
Total current portion	$ 48,533	$ 49,099
Long-term:		
Grand prizes	$ 182,671	$ 198,835

Long-term liability activity of grand prize awards payable was as follows (in thousands):

Year ending June 30,	Beginning Balance	Increases	Decreases	Ending Balance
2004	$ 228,683	$ 14,455	$ (30,619)	$ 212,519
2003	$ 234,307	$ 24,678	$ (30,302)	$ 228,683

Liabilities for future payments of grand prize liabilities are summarized as follows (in thousands):

Year ending June 30,	
2005	$ 29,848
2006	29,848
2007	29,848
2008	29,847
2009	29,747
2010 through 2014	111,492
2015 through 2019	23,650
2020 through 2024	4,280
2025 through 2029	1,732
Total	290,292
Less unamortized discount	(77,773)
Total at present value	212,519
Less current portion	(29,848)
Total long term portion at present value	$ 182,671

NOTE 8 - ESTIMATED PRIZE LIABILITY (CONTINUED)

Estimated prize liability for grand prizes is based on the cost of U.S. Treasury zero coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. This adjustment of approximately $14,455,000 and $16,332,000 in 2004 and 2003, respectively, is included in interest expense. Interest expense for the years ended June 30, 2004 and 2003 consisted of (in thousands):

	2004	2003
Amortization of discount on estimated prize liability	$ 14,455	$ 16,332
Interest on notes payable	-	4
Total interest expense	$ 14,455	$ 16,336

NOTE 9 - RETIREMENT PLAN

The KLC has a defined contribution retirement plan (the Plan) which covers all full-time employees. Under the terms of the Plan, the KLC and employees each contribute 6.2% of the employee's earned annual base salary, as defined. Employees become eligible for participation and are fully vested at the date of employment for this portion of the Plan.

The KLC also makes a contribution equal to 8% of the employee's earned annual base salary. For this portion, employees hired prior to October 1, 1993 became eligible at the date of employment and are fully vested providing participation requirements are met. Employees hired after September 30, 1993 become eligible one year after the date of employment and are fully vested after five years of service providing participation requirements are met.

For 2004 and 2003, total payroll was approximately $9,450,000 and $9,151,000, respectively. During 2004 and 2003, the KLC's contributions were calculated using the base salary amount for full-time employees of $8,339,000 and $8,634,000, respectively, for the 6.2% employer match contribution, and $8,499,000 and $8,952,000, respectively, for the 8% additional employer contribution. Employer requirements and contributions actually made to the Plan were approximately $1,197,000 and $1,219,000 (14.2% and 13.8% of covered payroll) and employee contributions to the Plan were approximately $517,000 and $535,000 (6.20% of covered payroll) in 2004 and 2003, respectively.

In addition to the above defined contribution retirement plan, the KLC’s employees are also eligible to participate in two deferred compensation plans sponsored by the Commonwealth of Kentucky. These plans are organized as a Section 457 plan and as a Section 401(k) plan under the Internal Revenue Code. Both plans permit employees to defer a portion of their salary until future years. Deferred compensation is not available to employees until termination, retirement, death, or financial hardship. The Commonwealth of Kentucky’s Comprehensive Annual Financial reports should be referred to for further disclosures related to the deferred compensation plans.

NOTE 10 - LEASES

The KLC has entered into operating leases for the rental of office equipment and office and warehouse space under initial lease terms of one to five years.

Approximate minimum rental payments are (in thousands):

Year ending June 30,		
2005	$	134
2006		121
2007		110
2008		72
2009		-
Total	$	437

Total rental expense for 2004 and 2003 was approximately $1,273,000 and $1,770,000, respectively.

NOTE 11 - PAYMENTS TO THE COMMONWEALTH OF KENTUCKY

Payments to the Commonwealth of Kentucky represent transfers of funds from the KLC to the Commonwealth's general fund, the KEES Program Reserve Account, and the Affordable Housing Trust Fund. The payments to the general fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are used to benefit all Kentuckians. The payments to the KEES Program Reserve Account are used to provide college or technical school scholarships to Kentucky high school students. The payments to the Affordable Housing Trust Fund are used to address the critical housing needs of extremely low income Kentuckians. The amounts payable to the KEES Program Reserve Account and the Affordable Housing Trust Fund result from unclaimed prizes on instant and on-line games. Prizes not claimed within 180 days of drawing date for on-line games or game ending date for instant tickets are forfeited and considered unclaimed. In accordance with Kentucky Revised Statute (KRS) 154A.110(3), any unclaimed prize money from these games may be retained by the KLC and added to the pool from which future prizes are to be awarded or used for special prize promotions, or may be appropriated by the General Assembly directly from the KLC for any public purpose. During the year ended June 30, 2004, all unclaimed prize money was transferred to the KEES Program Reserve Account as required by general assembly house bill 03HB269. During the year ended June 30, 2003, unclaimed prize money in excess of $6,000,000, not to exceed $3,300,000, was transferred to the Affordable Housing Trust Fund, and unclaimed prize money in excess of $9,300,000 was transferred to the KEES Program Reserve Account as required by general assembly house bill 03HB269. Payments are made as necessary, generally during January and/or July of each fiscal year, depending on the volume of unclaimed prizes.

NOTE 11 - PAYMENTS TO THE COMMONWEALTH OF KENTUCKY (CONTINUED)

Payments to the Commonwealth of Kentucky for the years ended June 30, 2004 and 2003 included payments to the following funds (in thousands):

	2004	2003
General fund	$ 182,052	$ 173,800
KEES scholarship reserve fund	11,426	3,629
Affordable housing trust fund	-	3,300
	$ 193,478	$ 180,729

Payments to the general fund for the years ended June 30, 2004 and 2003 included approximately $146,000,000 and $112,000,000, respectively, that were required by KRS 154A.130(4)(b) to be credited from the general fund to the Wallace G. Wilkinson Educational Excellence Scholarship Fund, the Collaborative Center for Literacy Development, the Early Reading Incentive Fund, the College Access Program and the Kentucky Tuition Grants Program.

NOTE 12 - RISK MANAGEMENT

The KLC is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. The KLC has purchased commercial insurance to cover these risks except for workers' compensation and damage to buildings and personal property for which the KLC utilizes the Commonwealth of Kentucky's Risk Management Fund to cover the exposure to these potential losses. The Commonwealth of Kentucky's Comprehensive Annual Financial Reports should be referred to for additional disclosures related to the Risk Management Fund. The KLC also retains risk of loss for the value of certain gaming equipment located at retail establishments. As of June 30, 2004, there were no outstanding liabilities or unpaid claims regarding this gaming equipment. The amount of commercial coverage has not significantly decreased nor has the amount of settlements exceeded coverage in any of the past three fiscal years. It is also the policy of the KLC to purchase a portion of the medical insurance needed to cover its employees.

NOTE 13 - COMMITMENTS AND CONTINGENCIES

In February 2004 a Jefferson Circuit Court jury awarded $2.8 million to the plaintiffs in a suit filed against the KLC. The suit included a Kentucky Civil Rights Act claim. The KLC filed an appeal in May 2004 and intends to continue to defend this action. If a liability is ultimately determined to exist the KLC has insurance coverage in place that would cover a significant portion if not all of any such liability. The ultimate outcome of this matter cannot be determined at this time, and as such, any potential adjustments to the financial statements are unknown.

NOTE 13 - COMMITMENTS AND CONTINGENCIES (CONTINUED)

In December 2002 a Jefferson Circuit Court jury awarded $4.3 million to the plaintiffs in a suit filed against the KLC. The suit included a retaliatory discharge claim under the Kentucky Civil Rights Act, a common law wrongful termination claim and a defamation claim. Upon a motion filed by the KLC, the Circuit Court vacated the jury verdict and ordered a new trial for a determination of liability and damages as to the defamation claim and for a determination of damages only as to the retaliatory discharge claim. The liability verdict on the retaliatory discharge claim was allowed to stand. The common law claim was dismissed. The new trial was held in August 2004 and a Jefferson Circuit Court jury awarded approximately $250,000 to the plaintiffs for damages on the retaliatory discharge claim. There was no finding of liability for the defamation claim. There has been no final judgment entered, however. The plaintiffs are also seeking $439,000 in attorney fees under the Kentucky Civil Rights Act, and the KLC has objected to the amount requested. A hearing will take place October 11, 2004, and, therefore, no final determination has been made by the Court in regard to the fees request. Seneca Insurance Company has defended the action on behalf of the KLC. The KLC intends to continue to defend this action vigorously, which may include an appeal to the Court of Appeals should all remedies at the Circuit Court level be exhausted. If liability is ultimately determined to exist, the insurance coverage provided by Seneca should cover a significant portion if not all of any such liability. The ultimate outcome of this matter cannot be determined at this time, and as such, any potential adjustments to the financial statements are unknown.

From time to time, the KLC is party to lawsuits and claims arising in the normal course of business. The KLC has defended and intends to continue to defend these actions vigorously and believes, based on currently available information, settlements, if any, will not be material to the financial statements.

MOORE STEPHENS POTTER LLP
CERTIFIED PUBLIC ACCOUNTANTS • BUSINESS ADVISORS

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Auditor of Public Accounts, Commonwealth of Kentucky and
the Board of Directors, Kentucky Lottery Corporation

We have audited the financial statements of the Kentucky Lottery Corporation (the KLC) as of and for the year ended June 30, 2004, and we have issued our report thereon dated August 5, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the KLC's financial statements are free of material misstatement, we performed tests of compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the KLC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the audit committee, management of the KLC and the Auditor of Public Accounts of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties.

Moore Stephens Potter, LLP

MOORE STEPHENS POTTER, LLP
August 5, 2004

KENTUCKY LOTTERY CORPORATION
SCHEDULE OF FINDINGS
Year Ended June 30, 2004

Schedule of auditor's results

We have issued an unqualified opinion, dated August 5, 2004, on the financial statements of the Kentucky Lottery Corporation as of and for the year ended June 30, 2004.

Our audit disclosed no instances of noncompliance which are material to the Kentucky Lottery Corporation's financial statements.

Findings relating to the financial statements

Our audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.

KENTUCKY LOTTERY CORPORATION
SCHEDULE OF PRIOR AUDIT FINDINGS AND THEIR RESOLUTIONS
Year Ended June 30, 2003

The prior year's audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.